# Intangible Quality

**Steven Zicherman**, CFA
Equity Analyst, Investment Research

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Let’s start with a question. Say I offer you a penny today that doubles every day for a month or a million dollars. Which would you choose?

You’re probably guessing it’s a trick question.

You’re right. That penny would be worth $10.7 million after doubling 31 times. The power of compounding isn’t always obvious. It takes time to realize its force.

Like the penny, great businesses create value through compounding.

Visa is one example. It went public in March 2008. Had you invested $1,000 at the time, your investment would be worth just over $20,000 today.

We are constantly on the lookout for investment opportunities that can generate above-average performance like Visa. Over the course of my experience investing, it has become more and more apparent that the way to compound wealth and generate great long-term returns is to invest in quality companies at reasonable prices.


So how do we define quality? Quality companies typically have superior businesses, employees, management and opportunities to grow.

Today, I’m going to talk about why quality matters and why as investors, we should be relentless in our pursuit of owning best-in-class businesses in our portfolios.


You have all probably heard the commentators on BNN or CNBC go on and on about statistical company metrics like year-over-year revenue growth and price-to-earnings multiples.

While these are interesting and easy-to-reference facts about a company, ratios and growth rates are backward-looking by nature. They tell you about the past, not the future.

There are other, less tangible factors that reveal quality and drive long-term returns but are more difficult to measure or observe.


These factors include: effective capital allocation, outstanding communication, sustainable competitive advantages and delivering unique value. I’m going to speak to each of these points and provide some examples.

# Effective Capital Allocation


Capital allocation is how companies use cash. Most executives are great at operations and sales but few seem to know the right thing to do with the cash their business generates. The choices facing CEOs and Boards are wide-ranging and include investment decisions like expenditures and acquisitions but also decisions like dividend payments and share buybacks. These choices have a big impact on performance. For companies that we consider quality investments, allocation decisions are typically managed through a well-understood and disciplined process.

There are a few ways to screen companies for effective capital allocation, such as talking to management and listening to conference calls. We also like to read filings! Every so often we come across an annual report where the company explicitly outlines how they use cash.

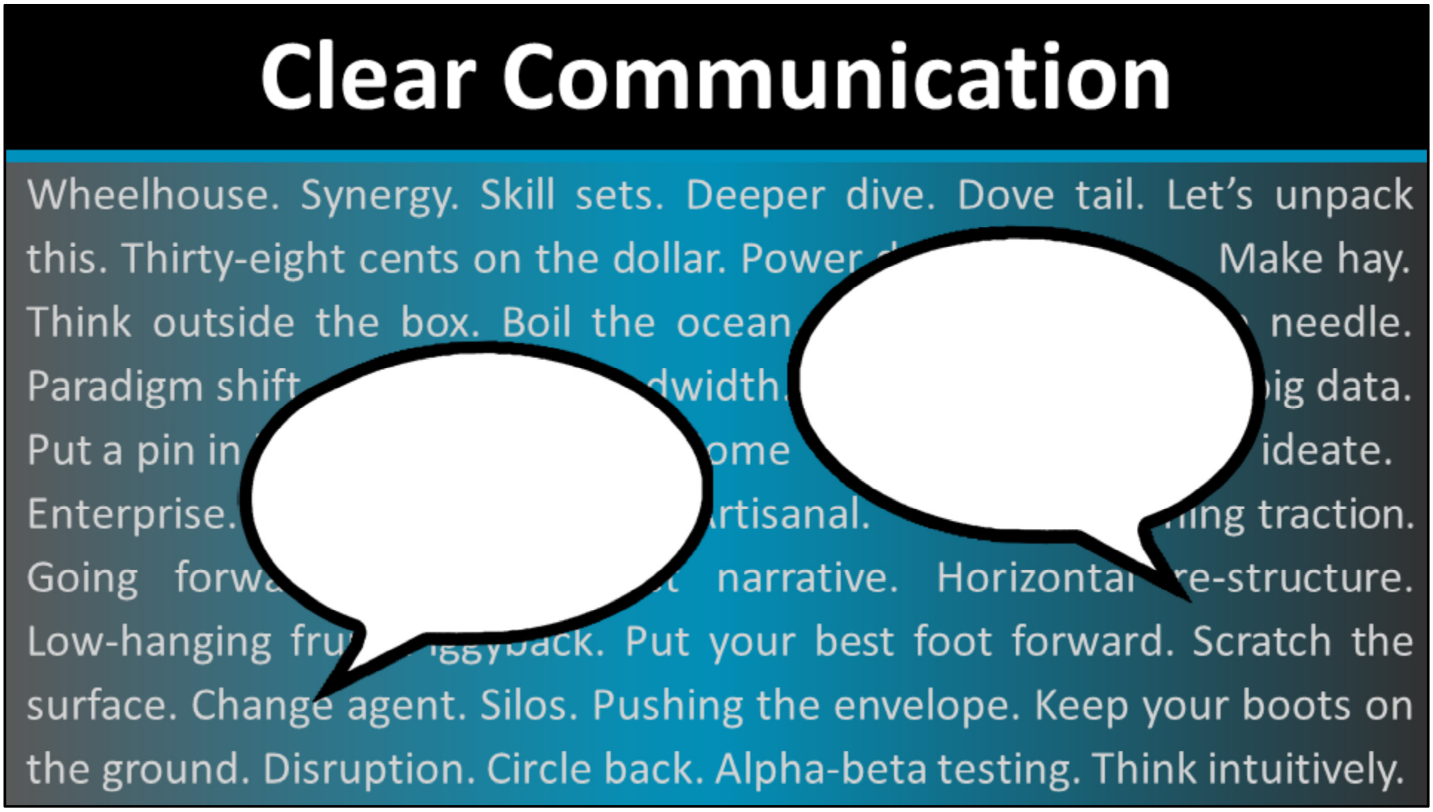
Constellation Software is one example.

The company is based in Toronto. Their business model is to acquire and manage smaller software businesses. The stock is up 10 times over the last seven years.

Constellation went public in 2006. If you read through their initial filing, you would find a summary of their framework for deploying cash. In fact, the filing states: "At the heart of our business model is the effective allocation of our capital."

They're not just talking the talk. Constellation reinforces its focus on allocation through its executive compensation structure, which we find reassuring. Management is rewarded for growing their businesses and making acquisitions that go on to generate great returns. Furthermore, senior executives are required to invest 75% of their bonus in the company and hold those shares for a minimum of five years. We generally like companies run by managers with "skin in the game."

Another way to filter for quality businesses is by looking at the way their leadership communicates.




Most "corporate speak" is confusing when all we want is open and transparent communication.

A company's annual report often contains clues about management's ability to communicate effectively. If a report has huge portrait photographs of top management, but little in terms of substance, like strategy and performance, we take note. In fact, just by reading an annual report, we are in the minority of investors still doing fundamental analysis of the companies we invest in.


Jeff Bezos and Warren Buffett are both great at conveying their respective priorities.

Bezos often stresses how Amazon needs to remain obsessed with customer satisfaction. People working at Amazon understand the importance of making this goal a reality.

In order to make his letters more readable, Buffett says he writes as if he's talking to his family.

Both Buffett and Bezos excel at straightforward messaging. Good communication enables them to set company strategy and goals, while ensuring their people stay on course.

# Competitive Advantages

Quality companies also have durable competitive advantages.

It’s generally assumed that above-average returns diminish over time. In business school, they teach you that companies with high returns attract competition, which enters the market and drives down those high returns. They call this mean reversion.

We find that most great companies tend to stay great. We’ve highlighted this point in past Annual Addresses and newsletters. High-quality businesses often remain dominant and maintain their leadership positions over time.

We look to identify companies with sustainable competitive advantages, which include brand recognition, scale advantages and barriers to entry.


For instance, look at how well Apple is doing with the Apple Watch and AirPods. Apple sells more watches than the entire Swiss watch industry. Apple is great at leveraging their brand to introduce new products and expand their reach with customers.

Thanks to its size, Amazon is an expert at logistics. The company is increasing its presence in India by partnering with thousands of mom-and-pop neighbourhood shops to store and deliver goods. Imagine how much faster Amazon will get products to its customers as these partnerships grow.

Canadian Pacific Railway is one of six major North American railroads. It’s practically impossible for a new competitor to enter the market. Not only would it cost a fortune, the land requirements and regulatory hurdles would be overwhelming to a newcomer.

Quality companies with sustainable advantages such as these can also provide investors with safety during tough times. They usually have higher margins and less debt compared to the average company.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Finally, another way to differentiate quality businesses is by looking for companies that provide unique value to customers.

With $150 billion in sales, Costco is the third largest retailer in the world. While many of you have heard how physical retail is dying, Costco is in fact thriving. The company has generated a total return that is two times better than the S&P 500 Index over the past decade.

So how did they do it?

Costco doesn't make much on its products. As a matter of fact, they limit markups to 15% despite offering high-quality items.


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Instead, Costco makes money from membership fees.

Are you willing to spend $60 on a Costco membership to save hundreds, if not thousands, on goods?
I am.

When I'm at Costco, I don't bother to look up product reviews when shopping on impulse because I know that Costco quality is great. In essence, Costco competes on value, not price.


Great businesses treat their people well. Costco pays high wages and provides industry-leading benefits.

The average Costco employee makes $22 per hour compared to the industry average of $12. Treating people well leads to lower employee turnover, which also reduces costs for the company. So, value is high for Costco customers, high for Costco employees and rewarding for Costco shareholders.

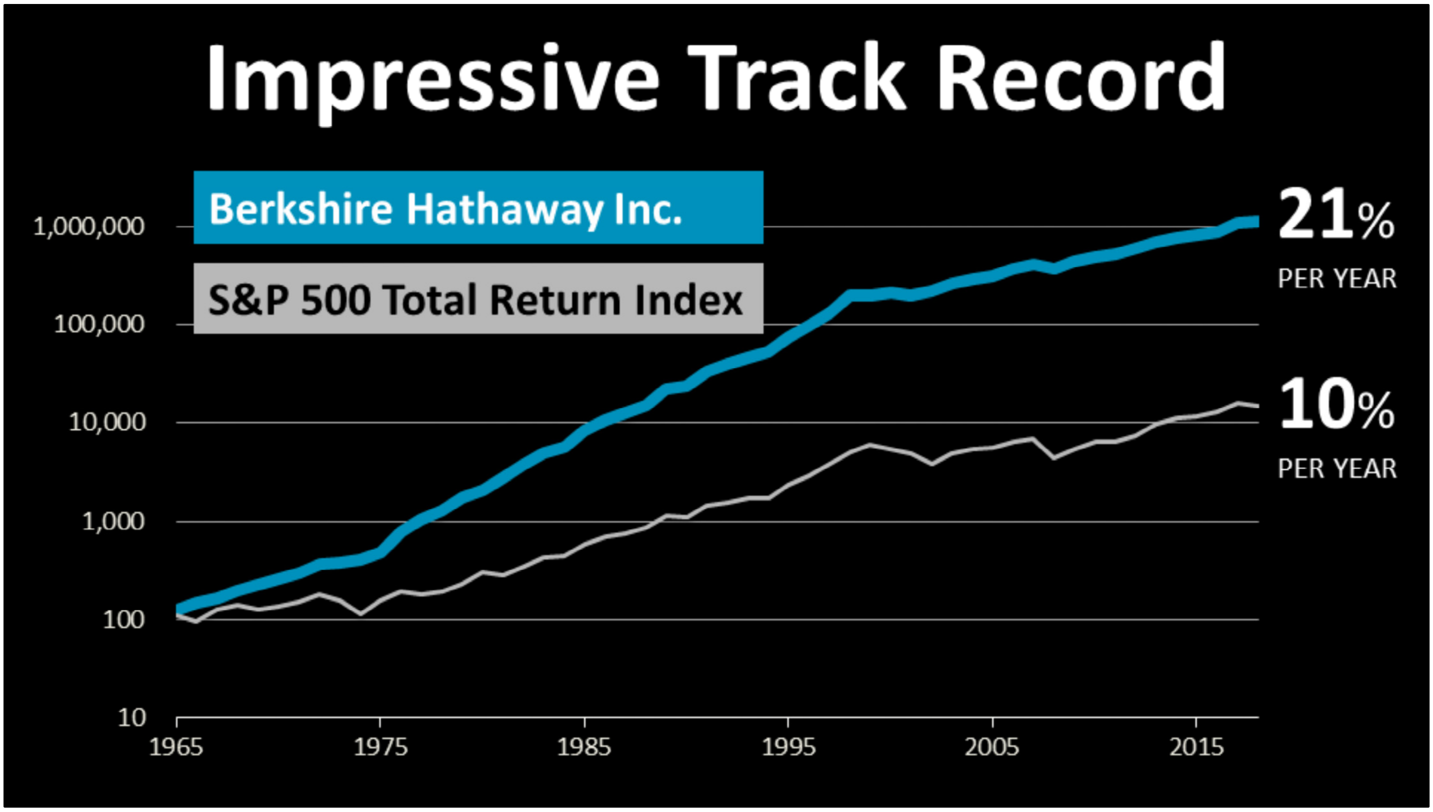
**Capital Allocation**

**Communication**

**Competitive Advantages**

**Unique Value**

When thinking about adding new holdings or selling certain names, we think about whether the company is a quality business. Beyond the financials, what really get us excited are the less tangible factors that we’ve discussed here today.




I often think of Warren Buffett's track record at Berkshire Hathaway. Since Buffett took control of Berkshire in 1965, the company has compounded by 21% annually, compared to 10% for the average American stock.

A study published in December 2018 examined Buffett's returns by analyzing factors that drove his performance. The revealing part of the study was the type of businesses that propelled his returns. While most people equate his success to a deep value approach and buying low price-to-earnings or low price-to-book stocks, Buffett's focus on quality has actually been a key factor in his outperformance. The results at Berkshire were most closely associated with its quality holdings.


As Buffett once said: “Whether we’re talking about socks or stocks, I like buying quality merchandise when it’s marked down.”


Remember the penny and how it grew to over $10 million due to compounding? It takes time for investments to realize meaningful returns too.

The returns that a company achieves today are usually the result of capital spent years ago. As investors we require patience. It takes patience to read annual reports to weed out weaker businesses from their best-in-class peers. It also takes patience to hold on to great companies.

For us, spending the time to understand what makes a company a quality business is important. Owning companies with great capital allocation, outstanding leadership and durable advantages and holding those investments through the inevitable market ups and downs is key to achieving our goals.

We try to identify companies that will be bigger, better and stronger in five years. Quality names like Constellation Software, Amazon, Apple, Berkshire Hathaway, Canadian Pacific and Costco fit this description and give us confidence that we have the building blocks of a great portfolio.

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